SUBMISSION BY THE

Housing Industry Association

to the

Productivity Commission

on the

Review of Australia's Consumer Policy Framework Draft Report

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Contact Details

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RECOMMENDATIONS

1. Prior to any further recommendations the Productivity Commission should investigate and document the actual incidence of market failure or deficiencies of existing consumer protection mechanisms (including common law remedies) within residential building industry and detail its assessment of how the benefits of additional regulation outweigh the costs.

2. Prior to recommending a revamp of Home Builders Warranty Insurance (HBWI), the Productivity Commission should undertake a comprehensive review of the way in which risk is allocated and managed in the home building industry, including the development of fair but speedy mechanisms for resolving disputes about defective work.

3. A new and properly designed ADR process that separates contractual disputes from factual disputes over defects may provide relief without imposing additional regulatory burdens on consumers and builders.

NO EVIDENCE OF MARKET FAILURE

Within the context of a general review of generic consumer protection legislation the Productivity Commission has made several draft recommendations considering reform of regulations specific to the residential building industry.

It has made these recommendations on the basis of selective perceptions that certain elements of the existing regimes are not protecting consumers.

It has not detailed or confirmed the existence of market failure or the failure of the existing processes by which remedies may be sought. Nor has it provided any analysis of the benefits versus costs of further protection.

For example, draft Recommendation 5.1 states that Home Builder's Warranty insurance ('HBWI') should be revamped to ensure that it is of genuine value to consumers. This value statement needs justification and assumes either that the price of the insurance is inappropriate for the risk insured or that a broader category of risks should be covered.

Justifying the first assumption requires an analysis of whether, and to what extent, existing insurance is being inappropriately priced. Only if insurers are over-pricing can it be said that the industry and consumers are not getting value for money. This analysis has not been undertaken.

Justifying the second assumption involves a cost/benefit analysis. The cost of insurance represents the risk insured. Revamping the insurance means increasing the risk and therefore the premium. This expanded risk needs to be identified along with the likely increase in premium. This analysis is lacking.

Further, the increased premium needs to be worth paying. For example, the Victorian Building Commission estimates that in Victoria there are 2 disputes per 100 building permit issued[1]. It should also be noted that 45 per cent of these are resolved without arbitration[2]. This is consistent with data showing that around 1 in every 100 building permits results in a claim

[1] www.pulse.buildingcommission.com.au, table S3-03
[2] www.pulse.buildingcommission.com.au, table S3-05

before VCAT[3]. Further, consumers report an average of nearly 80% satisfaction rating with their domestic building project.[4]

If consumers are highly satisfied and if only 1per cent of domestic building projects end up in arbitration then why should all consumers bear a significant increase in premium just to revamp an insurance package that they will almost never need?

Answering this question requires an analysis of likely insurance increases from suggested revamps and a comparison of that cost compared to the benefit provided. This analysis is not apparent from the draft report.

[3] www.pulse.buildingcommission.com.au, table S3-07
[4] www.pulse.buildingcommission.com.au, table S2-01

WHY THE QUEENSLAND MODEL IS FLAWED

It is not true to say that the Queensland model of state-run HBWI is generally seen to be working well. There is a fundamental structural conflicts of interest built into the Building Services Authority's (BSA's) operations as a licenser and insurer. Furthermore the system imposes additional expense and arguably poses inevitable conflicts of interest that arise when the monopoly insurer is also the consumer advocate and the regulator.

For example, published premiums as at July 2007 show that the BSA premiums are around $7.90 per $1,000 of contract value[5]. In contrast premiums in NSW were $6.14 per $1,000 of contract value in June 07, down from $6.89 per $1,000 of contract value in September of the previous year.[6]

This cost differential is the inevitable outcome of a state run monopoly that is insurer, regulator, and consumer advocate. When State Governments in NSW and Victoria ran a monopoly warranty insurance scheme the administration was widely criticised in both states for poor claims and financial management.

Part of the role of insurance is to influence behaviour through price signals, communicated via premium differences. Good behaviour is rewarded through lower premiums. This is true of private sector warranty insurers who have been innovative in developing alternative policy styles, administrative systems tailored to the needs of different builders, premium rating and distribution systems.

Under the Queensland model this role is subverted because all builders are charged the same premium irrespective of their capacity and financial strength. Instead, the feedback mechanism is through the enforcement of rectification orders and threats of license cancellation. This is not insurance. It is a tax or a levy designed to fund enforcement.

This leads inevitably to allegations of coercion from BSA inspectors to builders that they should fix any consumer complaint (and hence avoid an insurance claim to the BSA) or else risk losing their licence and difficulties with the tender system to have work carried out resulting in inflated prices being paid for such work.

[5] Insurance Premium Table Effective 1 July 2007, Building Services Authority 31 May 2007
[6] NSW Home Warranty Scheme Report NSW Office of Fair Trading, 30 June 2007, p12 Table D3.1

WHY HBWI CANNOT BE CONSIDERED IN ISOLATION

The problems with the Queensland system demonstrate that it is not possible to review HBWI in isolation to the overall regulation of the industry because there may be other and better ways of allocating and managing risks than insurance.

Insurance is simply one way of managing risk. It is best applied to manage unacceptable risks that can not be managed in any other way. Insurance becomes expensive when it is used to manage too many risks.

The Productivity Commission has previously noted that:

> *" Actions to change insurance requirements must also take into account the interlinkages between the various compliance mechanisms operating in the building regulatory framework"* [7]

These compliance mechanisms include:

- Licence qualifications which are designed to weed out the worst operators.
- Licence review and cancellation processes which are designed to exclude from the market those who have demonstrated they are unable to satisfy consumers.
- Laws which limit the amount of money builders can charge up front and the timing and quantum of progress payments allow consumers to manage risk by refusing to pay for defective work.
- Statutory warranties which protect current and future owners against defects.

All of these impact on the cost of insuring consumers against the risk of defective work. Better trained operators mean fewer disputes and less claims. More rigorous enforcement mechanisms means shonky operators are weeded from the industry, decreasing the overall risk profile of the industry. Better resourced builders mean under-capitalisation does not prevent builders from rectifying defects. Limiting progress claims helps curtail the costs of any claim by limiting the amount of money at stake is a builder does go bankrupt. Warranties that protect future purchasers mean

[7] Productivity Commisison 2004 *Reform of Building Regulation,* Research Report, p212

insurance is bearing the risk that could be managed in less costly ways, such as through pre-purchase inspections – and access to the inspector's professional indemnity insurance - and renegotiations of sale price.

No revamp of HBWI can proceed without comprehensively reviewing these other mechanisms reduces the effectiveness of any review. Revamping HBWI in isolation to make it do everything that consumer groups think it should do will make the product prohibitively expensive.

The Tasmanian Government deserves credit for recognizing this link. In announcing a move to voluntary HBWI it has also announced a package of regulatory changes that crucially include a streamlined process for resolving disputes over defective work.[8]

The single biggest reform required by both consumers and builders is in relation to the dispute resolution process. The Productivity Commission has touched on this issue and made it the subject of a broad recommendation, draft Recommendation 5.1. However, the recommendation should be more specific about the dispute process and should more explicitly link it to HBWI.

[8] *A New Consumer Building Framework,* Consultation Paper, Tasmanian Department of Justice Consumer Affairs and Fair Trading

WHY HBWI IS LINKED TO DISPUTE PROCESSES

The complaint against HBWI is that is triggered too late. That is, the consumer must exhaust all other legal avenues for forcing the builder to rectify faulty work before the insurer will accept a claim.

While the cover is effective in cases of bankruptcy or insolvency, it is of little assistance where the builder refuses to rectify faulty work. The cost of enforcement can exceed the cost of the defect, neutering the perceived benefit of the insurance.

The key to reforming HBWI therefore is to provide an earlier trigger. However, any form of first resort insurance will be expensive, potentially prohibitively so.

First resort HBWI is expensive is because it insures the consumer against an additional and entirely unmanageable risk: the risk of obtaining and enforcing a court order that work is defective.

HBWI is not legal fees insurance. It is designed to insure a consumer against the risk of their builder going bankrupt or otherwise failing to complete work, including rectifying defective work. It is priced accordingly. HBWI cannot rectify the deficiencies of the justice system. The risk of obtaining and enforcing a court order is not one the insurer can profitably insure.

HIA discussions with insurers about ways to improve HBWI without increasing costs indicate that HBWI insurers are not willing to provide insurance that is triggered simply because a builder has been ordered to rectify faulty work and failed to do so. This is because of the moral hazard involved.

However, insurers would be willing to provide insurance that is triggered upon cancellation of licenses. This creates new challenges since cancellation of licence is a serious issue that needs to exhibit high standards of natural justice.

'Revamping' HBWI, therefore, means implementing a dispute resolution process that, while being speedy and low cost, nevertheless provides a reasonable basis for ending the livelihood of those who fail to comply.

THE PRICINPLES OF A BETTER DISPUTE RESOLUTION PROCESS

Alternative Dispute Resolution (ADR) means different things to different people. In technical terms it means anything other than a court. It includes mediation, conciliation, and arbitration. But just recommending that disputes be determined in some other way than a through a court is not the answer.

As noted above, the building industry needs a dispute process that provides a reasonable basis for ending the livelihood of those who fail to comply. Mediation, while useful part of any process, does not provide a basis for revamping HBWI. You can hardly cancel someone's licence and trigger warranty insurance just because they have failed to agree.

An appropriate dispute resolution mechanism would demonstrate the following three principles and their related sub-principles.

<u>Principle 1: Segmentation of Disputes</u>
First, it would separate contractual disputes from factual disputes about defects. Contractual disputes are arguments about the terms of the contract rather than the quality of the work. It includes disputes about agreed variations and alleged misrepresentations. Factual disputes are disputes about whether work is defective or not.

It is a mistake to treat both types of disputes in the same manner through some kind of quasi-court arbitration process. These processes are either rigorous and so become as delayed and unwieldy as traditional courts, or they become so quick and dirty that there is little confidence in their ability to deal appropriately with legal issues.

This problem can be solved by applying different processes to different types of disputes.

> <u>Deal With Contractual Disputes Through The Courts</u>
> Contractual disputes should be heard by courts because they deal with issues of contractual rights, equity rights such as *quantum meruit* claims, and breaches of the Trade Practices Act, such as claims of misleading and deceptive conduct.
>
> <u>Deal With Defect Disputes Through Expert on-Site Arbitration</u>
> On the other hand, factual disputes about whether work is defective can and should be determined through on-site expert arbitration. A person with appropriate qualifications and training

should be empowered to make binding determinations about whether work is defective and how long it should take for that defect to be rectified. Such a process would take days and not weeks or months.

Principle 2: Ensure the System Is Independent and Fair

It is crucial that all parties – builders, consumers, and insurers - have faith in the independence and integrity of the dispute resolution process and its outcomes. This implies several sub-principles.

Not Overseen By Consumer Affairs

First, the process must be independent of consumer affairs agencies. Such agencies may be advocates for consumers within the dispute process but they should not be the arbitrator or the regulator. The process needs to be overseen by the justice or the building regulation machinery within the relevant government.

Agreed Definition Of Defect

To underpin the integrity of the system, what is a 'defect' needs to be defined and clearly understood. Imperfect work is not necessarily defective work. Disputes often arise because working in open environments with living materials inevitably means work can be imperfect.

The appropriate way to define 'defect' is through a standard guide of tolerances. This guide would prevent the expert arbitrator from substituting their own view or workmanship standards for the acceptable standard.

Open To Builder's To Initiate

Finally, the process needs to be equally a mechanism for builders to resolve disputes with consumers and not just a consumer initiated process.

It is simply not true to say that the builder always has power in the relationship. Laws that limit the amount a builder can charge for deposit and the timing and quantum of progress payments mean builders are always working at a loss.

Small builders in particular rely on the final payment to cover expenses and make profit. Consumers have the power to award themselves a discount simply by withholding the final payment

because of alleged defects and trusting that it will never be worth the builder's while to pursue them.

Builders need protection against this form of economic hold up. They need a process for challenging bogus claims of defective work and for enforceable orders that money should be paid.

<u>Principle 3: Rights of Appeal As Speedy As Initial Decision</u>
Any dispute process that potentially results a person losing their livelihood will need a right of appeal.

The tendency here is for appeals to be handled by some form of Tribunal. It makes the appeal process as unwieldy as the court the process it was designed to replace and undermines the purpose and intent of having a speedy, expert arbitration.

Instead, the appeal process for factual disputes about defects should involve a review of the site by further experts, either a panel or a more senior expert designated for that purpose.

Assuming the above criteria are met, it would be reasonable and practical to tie the dispute resolution process to HBWI.

If through a fair and independent process a builder's work has been declared defective and that work has not been rectified - despite appeal rights being exhausted or not activated - then it would be fair and reasonable to cancel the practitioner's licence and trigger warranty insurance.

Such an outcome would deliver better consumer protection, protect the integrity of the licence system, and insure premiums are kept low by excluding demonstrably shoddy practitioners from the market.

However, reaching this point relies on a willingness to comprehensively review the way the risk of defective work is managed together with the costs and benefits of different regulatory mechanisms. It is a lot more involved than simply revamping HBWI.